INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	3
Argument	5
Conclusion	10

CITATIONS

Cases:

Arrowsmith v. *Commissioner*, 344 U.S. 6 ..... 4, 5, 6, 7, 8
Commissioner v. *Anders*, 414 F. 2d 1283, certiorari denied, 396 U.S. 958 6
Deputy v. *duPont*, 308 U.S. 488 8
Interstate Transit Lines v. *Commissioner*, 319 U.S. 590 8
Lanrao, Inc. v. *United States*, 422 F. 2d 481, certiorari denied, 398 U.S. 928 6
Lykes v. *United States*, 343 U.S. 118 8
United States v. *Gilmore*, 372 U.S. 39 8
United States v. *Hilton Hotels Corp.*, 397 U.S. 580 6
United States v. *Skelly Oil Co.*, 394 U.S. 678 ..... 4, 5, 6, 7, 8
Welch v. *Helvering*, 290 U.S. 111 8
West Seattle Natl. Bank v. *Commissioner*, 288 F. 2d 47 6
Woodward v. *Commissioner*, 397 U.S. 572 ..... 6, 8

Statutes:

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 162 2
Sec. 262 8
Sec. 1221 3
Sec. 1222 3

Securities Exchange Act of 1934, c. 404, 48 Stat. 881, 896 (15 U.S.C. 78p):

Sec. 16(b) 2-3, 4, 7

In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 924

WILLIAM L. MITCHELL and MARIAN S. MITCHELL,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 11-21) is reported at 52 T.C. 170. The opinion of the court of appeals (Pet. App. 22-31) is reported at 428 F. 2d 259.

JURISDICTION

The judgment of the court of appeals was entered on June 18, 1970. A petition for rehearing en banc was denied on August 7, 1970 (Pet. App. 32). The

petition for a writ of certiorari was filed on November 2, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a payment made by petitioner[1] to his employer which had its genesis in a transaction in which petitioner realized a long-term capital gain should be treated as a long-term capital loss.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

> SEC. 162. TRADE OR BUSINESS EXPENSES.
>
> (a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *
>
> * * * *

Securities Exchange Act of 1934, c. 404, 48 Stat. 881, 896 (15 U.S.C. 78p):

> Sec. 16. * * *
>
> (b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted

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[1] William L. Mitchell will be referred to as "petitioner." Marian S. Mitchell is a party to this suit only because a joint income tax return was filed for the year in issue.

security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; * * *.

* * * *

STATEMENT

In October 1962 petitioner, a vice president of General Motors Corporation, sold 2,736 shares of General Motors common stock. After commissions and taxes, petitioner netted $115,535 on the sale of 2,130 of these shares. He reported the profit on the transaction as a long-term capital gain [2] on his 1962 income tax return. In January 1963, petitioner exercised a restricted stock option, granted him in 1959, to purchase 2,130 shares of General Motors common stock, for which he paid $97,596.60. At the time of the sale and purchase, petitioner was unaware of the provisions of Section 16(b) of the Securities Ex-

[2] See Code Sections 1221 and 1222.

change Act of 1934, c. 404, 48 Stat. 881, 896 (15 U.S.C. 78p), pp. 2-3, *supra*, which prohibits the buying and selling or the selling and buying within a six-month period of the stock of a corporation by an "insider." Section 16(b) further provides that if such a transaction occurs the corporation must either be paid the differential in prices by the insider or report the amount as being owed the corporation on its annual report. (Pet. App. 23-24.)

After learning of the transactions, General Motors advised petitioner that in its opinion he violated Section 16(b), and accordingly made demand on petitioner for $17,939.29, representing the difference between the sale and purchase prices of the 2,130 shares of stock. Upon advice of his attorney petitioner paid this amount to General Motors in order to avoid possible litigation, as well as damage to his business reputation stemming from publication by General Motors of the transaction in its annual statement. (Pet. App. 24-25.)

On his income tax return for 1963 petitioner claimed deduction of the payment to General Motors as an ordinary and necessary business expense under Section 162(a) of the Internal Revenue Code of 1954, p. 2, *supra*. The Commissioner allowed only a long-term capital loss deduction. (Pet. App. 12.) The Tax Court overruled the Commissioner's determination (Pet. App. 11-21). On appeal, the Sixth Circuit reversed, holding that the tax benefit doctrine of *Arrowsmith* v. *Commissioner*, 344 U.S. 6, as applied in *United States* v. *Skelly Oil Co.*, 394 U.S. 678,

was applicable, and accordingly sustained the Commissioner's determination (Pet. App. 22-31.)

ARGUMENT

The decision below is correct. No conflict exists or is asserted, and there is no other reason for further review.

1. The disposition of this case is governed by this Court's decisions in *Arrowsmith* v. *Commissioner*, 344 U.S. 6, and *United States* v. *Skelly Oil Co.*, 394 U.S. 678, with which the decision below is in complete accord. In *Arrowsmith* this Court held that a payment in satisfaction of a liability arising from a capital transaction which produced a capital gain in a prior taxable year carries the same (capital) character as the transaction from which the liability arose, and hence was deductible in the year of payment only as a capital loss, not as an ordinary loss or expense. The Court reasoned that since the taxpayer enjoyed preferential capital gain treatment of the transaction in the prior year, his later payment stemming from the same transaction was in the nature of a refund of a portion of that capital gain, and that to permit offset of the payment against ordinary income would in effect grant the taxpayer a double tax benefit, a result manifestly contrary to the congressional intent.

In *Skelly Oil*, the Court, applying the tax benefit doctrine of *Arrowsmith*, held that a taxpayer which had reduced its taxable income in a prior year by the percentage depletion allowance was not entitled to deduct in full a refund payment it was subsequently

required to make.[3] Relying upon *Arrowsmith* for the proposition that "the prior year may be examined to determine whether the repayment gives rise to a regular loss or a capital loss," this Court observed that "[t]he rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income" (394 U.S. at 684-685).[4]

Here, as in *Arrowsmith*, the taxpayer is seeking an ordinary deduction for a payment made to discharge his liability arising from a transaction which produced a long-term capital gain in a prior taxable year. The payment was made in 1963 to restore to petitioner's corporate employer (General Motors) an

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[3] The Tax Court failed to mention *Skelly Oil* in its opinion. As the court below noted (Pet. App. 27), *Skelly Oil* was decided only nine days before the Tax Court decision in this case, and presumably it was then unaware of the *Skelly Oil* opinion.

[4] The tax benefit rule applies equally to the converse situation, *i.e.*, recovery of an amount deducted from ordinary income in a prior taxable year must be restored to ordinary income in the year of recovery. See, *e.g.*, *Commissioner* v. *Anders*, 414 F. 2d 1283 (C.A. 10), certiorari denied, 396 U.S. 958; *West Seattle Natl. Bank* v. *Commissioner*, 288 F. 2d 47 (C.A. 9).

Essentially the same rationale underlies the now settled rule that expenses related to the purchase or sale of a capital asset are not deductible as ordinary business expenses, but are to be reflected in the computation of the capital gain or loss realized on the sale. *Woodward* v. *Commissioner*, 397 U.S. 572; *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580; *Lanrao, Inc.* v. *United States*, 422 F. 2d 481 (C.A. 6), certiorari denied, 398 U.S. 928.

alleged "insider" profit realized from his General Motors stock sale-purchase transaction in violation in Section 16(b) of the Securities and Exchange Act of 1934, which profit petitioner had reported in 1962 as long-term capital gain. In harmony with this Court's rulings in *Arrowsmith* and *Skelly Oil*, the court below correctly held that the refund payment, having had its genesis in the capital gain transaction, was deductible as a capital loss, not as an ordinary business expense.

2. In an effort to distinguish or avoid the impact of *Arrowsmith* and *Skelly Oil* petitioner advances a variety of arguments. None has merit.

(a) Petitioner's contention (Pet. 7) that the payment in question "had no relationship" to the prior sale of his General Motors stock is, as the court below pointed out (Pet. App. 30), "contradicted by his own testimony." It is also refuted by the conceded fact (Pet. 3) that the payment was made to comply with the demand by General Motors to restore the alleged illegal "insider" profit realized by petitioner on his sale of General Motors stock (reported at the preferred long-term capital gain rate), and thereby avoid possible litigation. In the words of the court of appeals (Pet. App. 31), "[e]xcept for the sale of the stock in 1962, which resulted in a long-term capital gain, the alleged violation of § 16(b) and the payment of $17,939.20 to General Motors would never have occurred."

(b) Equally untenable is petitioner's claim (Pet. 7) that the payment qualifies for deduction as an ordinary business expense because it was also made to protect his business reputation. Quite apart from

the fact that it is the "origin and nature" of an expense rather than the taxpayer's subjective intent which is determinative of the right to the deduction (*Deputy* v. *duPont*, 308 U.S. 488, 494-496; *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 594), a payment made to protect one's business reputation and goodwill is a capital expenditure (*Welch* v. *Helvering*, 290 U.S. 111). Accordingly, as the court below observed (Pet. App. 30), petitioner's "business purpose * * * [is] irrelevant in determining whether the tax benefit doctrine of *Arrowsmith* applies."[5]

(c) As for petitioner's attempt (Pet. 5-6) to analogize the payment here involved to compensation paid by an employer to his employees out of the proceeds of a sale of capital assets, the opinion below does not even remotely suggest that the deductibility of compensation payments—or, for that matter of any other ordinary business expense—depends on the monetary source of the payments, rather than their tax character. What the court below did hold, in keeping with this Court's decisions in *Arrowsmith* and *Skelly Oil*, is that a taxpayer may not enjoy a double tax benefit where, as here, he seeks an ordinary deduction for a payment which had its genesis in a transaction from

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[5] That a payment is made for "business" reasons may be relevant in determining whether it falls outside the category of non-deductible "personal" expenses (see Code Section 262; *Lykes* v. *United States*, 343 U.S. 118; *United States* v. *Gilmore*, 372 U.S. 39), but is not determinative of whether it is capital or ordinary in nature (see *Arrowsmith* v. *Commissioner*, *supra*; *United States* v. *Skelly Oil*, *supra*; *Woodward* v. *Commissioner*, *supra*).

which he realized a long-term capital gain.[6] Unlike the payment here involved, which extinguished a liability rooted in the self-same capital transaction from which petitioner realized capital gain, a taxpayer's liability to pay for services arises independently of any other transaction, capital or otherwise.

3. Petitioner does not and cannot allege conflict. Instead, he alludes generally (Pet. 8) to four unspecified "similar" cases pending "at some stage of the administrative process" and requests this Court to review the decision below in order to "establish one uniform precedent." Our inquiry at both the Internal Revenue Service and of petitioner's counsel fails to disclose any case pending at the administrative level involving the issue here presented. In any event, taxpayer cites no conflicting court decision, and we know of none.

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[6] As the Sixth Circuit explained (Pet. App. 30), "[u]nder *Arrowsmith* and *Skelly Oil*, when income is given up, which in its inception was taxed at reduced rates, the taxpayer is not permitted to enjoy preferred treatment twice by deducting in full the extra amount given up as an ordinary deduction."

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

JOHNNIE M. WALTERS,
Assistant Attorney General.

HARRY BAUM,
KENNETH L. GROSS,
Attorneys.

DECEMBER 1970.

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